

The Buy-in: Transitioning from Employee to Partner

Whether you have just completed your residency or fellowship training or have already been in private practice for a few years, it is never too early to begin thinking about becoming a partner-owner in a practice. Partnership in a practice is a logical evolution, which likely was discussed (and possibly memorialized, at least to some degree) by the negotiating parties during the initial recruitment/hiring process. Now is the time to understand the key elements involved in a buy-in.

Key Elements

The basic premises of any buy/sell arrangement are to (1) create and maintain an equitable economic relationship among the owners, (2) allow ownership to be financially feasible for the new owner, (3) recognize the value of practice shares being sold, (4) provide a mechanism for practice succession and stability as prior owners leave and new owners arrive, and (5) create appropriate balances between risk and reward. Ownership interests can be offered to an associate in a number of ways.

- *Equal Ownership:* The most common structure involves ownership of equal shares among all participants. For example, if two current owners each hold 500 shares, a new owner could be issued 500 new shares, or purchase $166\frac{2}{3}$ shares from each current owner. As a result, each shareholder would own equal positions in the practice, whether 500 shares each, or $333\frac{1}{3}$ shares each.
- *Partial Ownership:* A new associate can be offered a partial, or minority position, which is less than that owned by others. This option may be appropriate if the current ownership wishes to retain a majority position in the practice. Alternately, this option can allow an associate with modest financial means to enjoy the security of an ownership position without incurring the costs of an equal position. In the above example, the new associate could be issued 250 new shares and own 20 percent of the practice, while the current owners retain a 40 percent share each.
- *Incremental Ownership:* If a new owner has limited but improving financial means, share options can be offered, allowing optional purchase of incremental shares over a three- to five-year period. For example, the new associate could be offered a 4 percent interest in each of five consecutive years. If the options were exercised each year, the associate would eventually hold a 20 percent interest (five options at 4 percent each). If financial means allowed purchase in only three of the five years, a 12 percent interest would eventually be held (three options at 4 percent each).

Several critical issues must be addressed within any buy/sell structure.

- *Income Distribution:* Most smaller-sized practices use productivity-based systems for distribution of income, either exclusively or in combination with other methods. Productivity is usually measured by net collections received by the practice, with negotiated allocation of capitated revenue based on "points" or other systems. Some practices distribute income equally, which is most viable where productivity among owners varies by no more than 5 percent to 10 percent. Other practices use a combination of productivity- and equal-based methods, sometimes also using equity or other means as well. The income distribution structure greatly affects valuation of accounts receivable and goodwill for a new owner, as noted below.

- *Practice Valuation:* The value of the practice relevant to the new owner forms the basis for determination of purchase price per share. This value should reflect the value of owners' equity (adjusted to describe the fair market value of tangible assets), the new owner's access to proceeds from accounts receivable, and the new owner's access to distributable income of the practice. Various methods for valuation are available, primarily based on information within the tax returns or the balance sheet and income statement.

The buy-in for the owners' equity component of value should be based on the percentage of ownership. For example, a proposed 50 percent owner should be expected to pay 50 percent of the practice's owners' equity for that interest. On the other hand, the buy-in for accounts receivable and goodwill should be based on the new owner's access to income streams derived from the income distribution formula. For instance, if the new owner is to purchase a 50 percent share, and if the new owner were to represent 30 percent of production in a sole-productivity-based distribution system, the buy-in from accounts receivable and goodwill would be 30 percent of the total practice value for these items, reflecting the extent of the new owner's access to the practice earnings stream.

- *Cash Flow:* In most cases, the new owner should be able to cover buy-in payments while enjoying an increase in net compensation. Exceptions may occur if the associate's compensation during the employment period has been generous and comparable to owner income. In such cases, from a financial standpoint, the associate may find little motivation to pursue an ownership position.

The new owner should also enjoy reasonable compensation following deduction of the buy-in payments. Insufficient disposable income suggests either an overpriced buy-in or insufficient practice volume. In the former case, the valuation assumptions should be carefully reviewed to ensure that the relationship of income stream access and valuation is appropriate. In the latter case, the associate may need to continue as a non-owner until personal practice volume is sufficient to generate the income levels needed for the buy-in.

- *Payment Structures and Timeframes:* Payments can be made in different ways depending on the needs of the parties. In most cases, the buy-in amount is determined, then amortized by monthly payment at a modest interest rate over five to seven years. This structure, often called the "exact method," allows the buy-in amount to be determined with certainty, reflecting a practice valuation based on past performance.

Alternately, the new owner can buy into the practice through a combination of amortization and redistribution of income within the practice. Most commonly, the stock price is set, based on the value of equipment or owners' equity, then amortized as described above. However, buy-in amounts attributable to accounts receivable and goodwill are not paid directly. Instead, the new owner receives a discounted share of income under the owners' income distribution structure, usually on a graduated scale. A common scale involves payment at 60 percent to 70 percent in year one, 70 percent to 75 percent in year two, 80 percent in year three, 85 percent in year four, 90 percent in year five, and 100 percent thereafter. For example, if annual compensation otherwise payable to the new owner were \$200,000 under this scale, the redistributed income at the end of five years would be \$200,000, equal to the foregone compensation. This simple "inexact method" allows the new owner's future practice volume to determine the amount of buy-in payment, providing incentives for all parties to support practice growth for the new owner.

In most cases, the buy-in is financed by the practice, although the new owner may be required to obtain external financing. If financed internally, the buy-in period should allow a reasonable amortization of the debt, ensuring adequate cash flow for the new owner throughout the buy-in period. The buy-in period usually should not exceed five to seven years.

- *Tax Implications:* In general, payments for stock must be made with post-tax income of the new owner, while the current owners usually enjoy capital gains treatment as a result. Internal redistributions of income obviously result in no taxable event for the new owner, but

result in additional income to the current owners at their incremental rate of personal income tax.

The allocation of buy-in payments can be negotiated to some extent but is subject to tax regulations governing such issues. In view of significant tax implications and complexity of tax law in such matters, the buy/sell transaction should be undertaken in consultation with qualified tax advisors.

- *Buy-Out Provisions:* The buy/sell structure should include provisions for valuation and payment in the event of any owner's termination, disability, retirement or death. These provisions are important for a new owner since the obligations for buy-out debt can be significant. Valuation methods should reflect the value of the terminated practice to the surviving owners. Payment provisions should protect the practice from having such obligations undermine its financial viability. Buyouts will be covered in more detail in a future article.

Effective buy/sell arrangements are vital to the continued viability of a practice. Such structures should be fair to the individual, provide appropriate incentives for each individual to support the practice, be consistent with goals and strategic objectives of the practice, and maintain the financial health of the operation.

Buy/sell structures can be effectively modified to meet the needs of all parties while following appropriate guidelines related to value, cash flow, tax regulation and financing. However, the complexity of such structures strongly suggests the need for consultation with appropriate financial, tax and legal advisors.

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